Task Force on the Future of the Canadian Financial Services Sector

September 1998

Report of the Task Force

change challenge opportunity

Highlights

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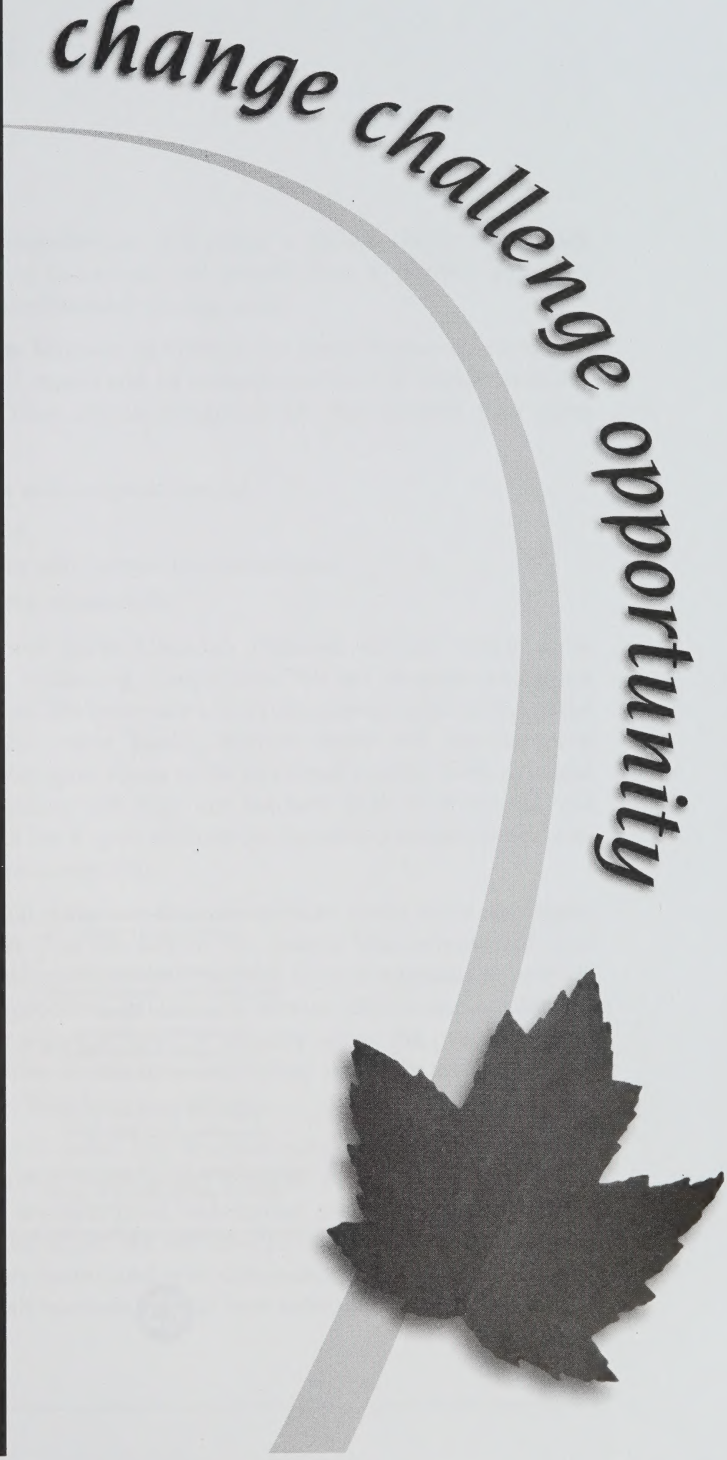

Cat No.: BT22-61/2-1998E
ISBN 0-662-27134-3

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Also available through the Internet at
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Cette publication est également disponible en français.

Highlights

Overview

The Task Force's recommendations will create a public policy framework within which Canada and Canadians can benefit from a healthy, dynamic, innovative and competitive financial services sector.

We have forwarded to the Minister of Finance our Final Report which is supported by five background papers and 18 research studies. The Report contains 124 recommendations. They are an integrated set that address four main themes:

- enhancing competition and competitiveness;
- empowering consumers;
- Canadians' expectations and corporate conduct; and
- improving the regulatory framework.

Our recommendations will make Canada's financial services sector more vibrant and dynamic by enhancing competition. We see stronger and more aggressive credit unions and life insurance companies emerging to challenge the dominant position of the major banks. Mutual funds will become even stronger competitors as they gain access to the payments system. New, dynamic and well-financed competitors will enter our markets, both from abroad and domestically. Chapter 6 of the Report sets out our detailed conclusions and recommendations to enhance competition.

Our recommendations will make our financial services sector more responsive to consumers. In Chapter 7 of the Report we discuss how empowered consumers can make more informed choices that will force institutions to provide consumer value in their products, pricing and service. Our recommendations will also give consumers a greater sense of security about the protection and use of their private, sensitive information, and easier and more effective access to corrective action when they have complaints.

Our recommendations will make our financial services sector healthier by strengthening the relationship between our financial institutions and the communities they serve. We see continued, substantial progress in making basic financial services available to all. We see new, productive partnerships being formed with the voluntary sector and with community organizations. Further progress in financing small business and the new economy will take place, and

our recommendations will increase understanding of what the problems are and what needs to be done. New Community Accountability Statements will provide a basis for constructive, focussed dialogue on how our institutions can serve Canadians better. Our conclusions and recommendations are discussed more fully in Chapter 8 of the Report.

Our recommendations will make our regulatory framework more flexible and more forward-looking. In Chapter 9 of the Report, we describe the development of a new culture of prudential regulation that will effectively balance the need for safety and soundness with the need to facilitate competition and innovation in our financial system.

Taken together, our recommendations, will create a public policy framework that is well positioned to respond to the challenge of change, and help Canadians realize the opportunities that come with change.

Within this framework, Canada's institutions must develop their own business strategies to adjust to change in ways that build on their own strengths and that secure their ability to grow and to prosper. In an increasingly competitive global marketplace, with enhanced competition in our domestic markets, strong and internationally competitive Canadian financial institutions bring benefits to all Canadians. A vibrant, dynamic Canadian controlled industry, with major players active and competitive in world markets, provides benefits at home by importing best practices from around the world, by repatriating export earnings, and by assisting Canadian businesses to operate abroad. Competitive domestic institutions also contribute to thriving domestic financial centres that offer value-added economic activity, innovation, higher tax revenues and high-quality employment that can keep our talented young people in Canada.

Chapter 6 of the Report sets out a number of recommendations that will increase the competitiveness of our financial institutions and expand the range of business strategies they can pursue.

Mergers are not the only strategic option that can be followed. But mergers should not be ruled out without a searching assessment of their benefits and their costs in public interest terms. We have recommended, in Chapter 6 of the Report, a merger review process that can be used by Government to judge whether mergers of large institutions are in the best interest of the country. The process is an open, transparent one that will get facts on the table and allow informed judgments to be made, hopefully in an environment that can be as free from rhetoric and emotion as possible.

The Report reviews the significant forces of change that are impacting the financial services sector around the world. It concludes that Canada cannot and should not stand aside from those forces. Canada benefits now from a

healthy financial services sector that, on balance, serves Canadians reasonably well. There is room for improvement, and there are new challenges that must be met. Our Report proposes a framework that will allow the sector to become an even stronger contributor to Canada in the coming decades.

The Challenges and Opportunities of Change

It is extraordinary how quickly the world is changing. Driven by technology and new ideas, the world is fundamentally different as we approach the millennium than it was even 10 or 15 years ago. The fall of communism and the spread of democracy and market economies, the continued integration of Europe and adoption of a single currency, the broadening and deepening of freer trade and investment, and the ascendancy of global capital markets are transforming how commerce is being conducted. There are implications for consumers, for industries, for governments and for regulators.

Change brings both challenge and opportunity. This is apparent in the financial services sector, where technology and new and innovative approaches to the management of risk are transforming the ways in which institutions compete with one another to serve customers who are becoming increasingly sophisticated.

For consumers, change offers a greater variety of products that can be accessed in many different ways. We see technology offering more convenience of access and broader choices that will lead to greater consumer value. However there are challenges that must be addressed as well. Products are becoming more complex and harder to understand. New, direct distribution channels are putting pressure on traditional channels such as bank branches and insurance agents, even as many consumers are not yet ready or willing to fully embrace new and less personal relationships with providers. As competition among providers intensifies, and the number of products they offer multiplies, opportunities increase for coercion and undue pressure at the point of sale. And technology raises concerns about the adequacy of current policies to protect personal privacy of financial and medical information.

For financial institutions, change presents many challenges. New sources of competition are emerging, as domestic markets are opened to the world by trade agreements and by technology. This competition will benefit consumers but is forcing existing institutions to rethink their strategic directions. As the report makes clear, there are many different strategies being followed. Consolidation through merger is a valid business strategy, but it is not the only valid business strategy. As institutions seek ways to build on their strengths to serve customers better, there will be tremendous opportunity for those that are successful.

Governments require a legislative framework that will allow change to be managed, by policymakers and by leaders in the private sector, in a way that benefits the public interest. Flexibility will be increasingly important. In a world where the pace and direction of change cannot be accurately predicted, it is important not to create a regulatory straitjacket that prevents the benefits of innovation and competition from being realized. At the same time, the assumption by financial institutions of new types of risks will put an even greater premium on ensuring that these institutions, which are custodians of other people's money, remain safe and sound.

Regulators are also facing many challenges. Financial conglomerates – often operating in many countries around the world – are becoming more widespread. Regulating such organizations effectively will require new regulatory techniques and approaches, based on greater understanding of risk management and greater reliance on effective internal governance processes. It also requires that regulators develop new skills and succeed in attracting excellent professional staff.

In a period of rapid change worldwide, Canada – its institutions and people – cannot and will not be immune from change. But recognizing the need to accept change does not mean that Canadians are without power to influence and shape the ways in which change will affect them. The forces of change are global but their impacts will be local. There is a role for public policy, and for government and industry action, to ensure that change is managed in a way that recognizes Canada's unique history and geography, and respects Canadian priorities.

Our Vision for the Financial Services Sector

If one's destination is unclear, it is hard to get there. We set out in Chapter 5 of the Report our vision of what a desirable financial services sector should look like, viewed from three perspectives: what consumers should expect, what a desirable structure should be, and what kind of regulatory framework would be most effective.

While our current financial system works well and has many desirable features, it falls short of our vision in a number of significant dimensions. Even in an environment that was more stable than the current one, we would wish to see many features of our system improved. In a time of turbulence like the present, our recommendations on how best to manage change in a way that moves us toward achieving the vision become even more important and urgent.

Major Recommendations

Our major recommendations are summarized below. Greater detail can be found in the report itself and the relevant background papers. In particular, Chapter 10 of the Report provides a complete list of recommendations.

Enhancing Competition and Competitiveness

We believe that Canadians will be best served by a dynamic, competitive marketplace, open to the world, with many successful Canadian providers and with opportunities for many new entrants. We believe that individual Canadians and small businesses, in particular, are not as well served as they should and can be.

Enhancing Competition

We present a focussed, four-point strategy to enhance competition.

The first point is to strengthen the position of existing participants in order to provide a more dynamic, competitive market. Our recommendations include:

- allowing life insurance companies, mutual funds and investment dealers to have access to the payments system directly, in order to provide transactions services to Canadians;
- new powers for credit unions to make them more effective, including the power to become or to form banks;
- support for the rapid demutualization of major life insurance companies, which will enhance their ability to compete with large banks;
- changes to deposit insurance for banks and policy holder compensation plans for life insurers that will reduce the competitive advantage that banks now enjoy without compromising the quality of depositor protection;
- the creation of optional, regulated holding companies that can allow institutions greater organizational flexibility that will enhance their competitiveness;
- a new, more flexible definition of wide-ownership that provides existing institutions with more scope for strategic alliances; and
- the ability for federal deposit-taking institutions to offer insurance and auto leasing to their customers through their branches, as some provincially regulated deposit-taking institutions now do.

The second point is to encourage new domestic participants. We recommend:

- a new consistent set of ownership rules for all financial institutions, including banks, that will make it easier and more attractive for new banks to start up. These rules include provisions for new cooperative banks;
- a change in approval procedures for new institutions so that they can be started with less capital and faster turnaround times; and
- a ten-year holiday from capital taxes for new financial institutions, so as not to unduly penalize them in their early years.

The third point is to make it easier for foreign financial institutions to serve Canadians. We recommend:

- rapid adoption of legislation to allow foreign banks to operate in Canada through branches of their foreign parent (as well as, or instead of, through Canadian subsidiaries, which are now allowed);
- extending the current exemption from withholding tax for debt incurred with a term of greater than five years to all arm's-length debt, regardless of term. This will make it more economic for foreign firms to lend money to Canadian businesses and increase competition in the credit market; and
- establishing a framework that will provide clear rules and new opportunities for foreign firms to make loans to Canadians without establishing a physical presence in Canada.

The fourth point is to empower consumers. Consumers who are more informed, more vigilant, and able to exercise their rights more easily will provide an important discipline that strengthens competition by ensuring that providers offering better products and services win out over those offering inferior value to customers. Our recommendations to empower consumers are discussed below.

Enhancing Competitiveness

This four-point strategy will strengthen competition in domestic markets. As competition intensifies, Canadian institutions will need to adjust to remain competitive. It is important for all of us that they do so.

A healthy, dynamic, innovative and competitive financial services sector is fundamental to our individual and collective well-being. Our financial institutions employ more than half a million Canadians directly. They also play a major role in allocating the savings of Canadians to productive investments – providing a return for individual Canadians while contributing to economic growth and job creation throughout the country. Canadians deal with banks,

trust companies, credit unions, insurance companies and other financial institutions on a regular basis, and trust them to manage some of their most sensitive and personal affairs. When financial institutions work well, our economy functions better and our personal lives are made easier. When they do not, financial institutions and economies can collapse. Opportunities disappear. The savings and sometimes the net worth of individuals can evaporate overnight. The experience of recent months in Asia and Russia makes these points in a dramatic way.

We make recommendations that will enhance the competitiveness of our financial institutions, with benefits to Canada and Canadians. Specifically, we recommend:

- the elimination, or modification of special capital taxes on financial institutions in order to make them more competitive and to remove disincentives to increase their capital base; and
- the modification of accounting principles relating to business combinations, in order to remove a competitive disadvantage suffered by Canadian financial institutions relative to U.S. institutions.

We believe that it is up to institutions to determine what business plans and strategies make most sense for them. It is important that public policy not put unnecessary constraints in the way of business decisions. Public policy should not second-guess business strategy. However, where a business strategy would entail unacceptable public interest costs, the public interest must prevail.

With respect to mergers, we recommend that all proposed mergers should be assessed on their merits and with a particular view to whether they are in the public interest. We recommend a process by which such mergers should be reviewed that includes:

- review by the Competition Bureau, the Superintendent of Financial Institutions and the Minister of Finance;
- a Public Interest Review Process for large mergers, through which the merger proponents would be required to table, for review and comment, a Public Interest Impact Assessment in which they discuss the public interest benefits and costs of the proposed merger and the measures they are prepared to put forward to increase benefits or to mitigate costs; and
- a clear ability in law for the Minister of Finance to accept enforceable undertakings from merger proponents, with severe sanctions for non-compliance with undertakings.

We believe that these recommendations strike an appropriate balance between enhancing competition in our domestic markets and ensuring that our Canadian institutions remain competitive at home and have the opportunity to compete effectively abroad.

Empowering Consumers

Consumers provide an important discipline to competition when they understand what is being offered to them, can comparison-shop, are in a position to make informed purchases, and have effective redress mechanisms when they are not treated properly. The current framework for consumer protection is not as effective as it should be in reducing the information and power imbalance between institutions and consumers. In addition to enhancing competition, there are other reasons to seek strong consumer protection measures. Individuals can enter into significant financial transactions with inadequate advice or understanding of the consequences of the transaction or of the alternatives available. Protecting consumers is important for individual Canadians, as well as for society.

Our recommendations with respect to disclosure and transparency:

- would mandate the disclosure of transaction-specific fees and commissions so that consumers have additional information to allow them to comparison shop in a meaningful way; and
- propose a multipartite process – involving governments, industry and consumer groups – to make marketing and sales documents used by financial institutions easier to understand.

With regard to privacy, we recommend that:

- the government introduce a comprehensive, legislated, privacy regime that will require financial institutions to adopt legally binding codes of conduct that include minimum privacy standards for the sector. Consent will have to be expressly provided and not implied. There will be strict protections against the inappropriate use of medical information. Consumers will have the ability to seek redress in respect of privacy matters to the financial services sector ombudsman or the courts and there should be meaningful civil remedies, including punitive damages.

Our recommendations in respect of tied selling:

- propose a ban on coercive tied selling that is modelled on the current provision but covers more potentially abusive practices and applies to all federally regulated financial institutions, not just banks;

- require institutions to provide to customers, prior to entering certain types of transactions, clear and written disclosure of what constitutes coercive tied selling and that it is illegal; and
- propose remedies for breach of the coercive tied selling provisions that include prosecution and private recourse through the ombudsman and court systems.

With respect to consumer redress, we recommend that:

- the government establish a financial sector ombudsman office, to which all federally regulated institutions would be required to belong. Provincial institutions should be encouraged to opt in as well;
- each member institution should be required to make available an internal ombudsman that would be the first recourse for consumers; and
- the new federal office should be structured in a way that engenders public confidence in its operations by focussing on independence, an appropriately broad mandate, easy accessibility, timely and effective mediation of complaints, and high visibility.

We also make recommendations aimed at increasing the proficiency standards of financial intermediaries, supporting provincial efforts to introduce more focussed and coordinated regulatory structures for all financial intermediaries, and eliminating occupational restrictions that limit competition without any consumer protection purpose.

Canadians' Expectations and Corporate Conduct

A critical part of our vision for the financial system is that all major participants in the sector should enjoy the confidence and support of Canadians. That is not the case today. In the report we examine the basis for the high expectations with regard to the behaviour of regulated financial institutions, particularly banks, and we conclude that the expectations are legitimate. We recommend a number of ways that financial institutions can meet these expectations and thereby strengthen the bonds between themselves and the communities they serve.

The financing of small and medium sized businesses and firms in knowledge-based industries poses particularly significant challenges. It is clear from the experience of the recession in the early 1990's, and the subsequent investigations of small business lending activity by no less than four Parliamentary and Government committees in 1994, that small business lending is an activity in which the community has a deep and continuing interest. Despite improvements in information about lending in these sectors since 1994, we found that the available data are still not adequate to provide a clear understanding of the various problems and potential policy approaches. We recommend that:

- government undertake a comprehensive information collection and analysis program, building on what is now available but substantially expanding coverage to include all suppliers of finance to small businesses and all forms of finance, including equity capital as well as debt;
- there be an annual report on the state of small business finance to the Industry Committee of the House of Commons, prepared by a dedicated analyst group within Industry Canada, and annual hearings by the Committee to consider the report;
- credit granting institutions, and particularly banks, should find ways to address the problems created by frequent turnover of business account managers, including establishing career-paths and compensation incentives that provide long-term, meaningful careers for community-based small business account managers;
- banks should decentralize decision-making further to the regional and local levels; and
- lenders should be prepared to make available more innovative financing packages, with appropriate pricing, for higher-risk borrowers who may now be denied financing.

We also make specific recommendations directed at reducing some of the barriers to effective financing of firms in knowledge based industries, and of aboriginal businesses.

We consider ways in which access to basic banking services can be increased and we recommend that:

- greater efforts should be made by governments to ensure user-friendly access to basic accounts by increasing the use of direct deposit of government cheques, providing low-cost identification where desired, and negotiating indemnity agreements that indemnify institutions against fraud for both customers and non-customers who wish to deposit or cash government cheques;
- institutions take seriously their agreements of February 1997 and December 1997, in which they undertook to make changes in policies and practices to address the access issue. In particular, institutions must do more to put in place the necessary internal processes and systems, including compensation incentives, to ensure that the agreements are understood and implemented by employees throughout the organization;
- institutions, as part of this process, post in their branches the terms and conditions of basic transactions accounts as well as the identification required to open one; and
- if acceptable progress is not made in a reasonable period, based on benchmark studies, then the government should legislate compliance with the

February and December 1997 agreements, with appropriate sanctions for non-compliance.

With regard to access to branches, we recommend that federally regulated deposit-taking institutions be required to give at least four months notice to close a branch. During the notice period they should work proactively with the community to explore alternatives to ease the transition. Provinces should consider a similar requirement for the deposit-taking institutions they regulate.

With respect to micro-credit, and relations with the voluntary sector, we recommend that financial institutions consider innovative partnerships that can help to advance the successful implementation and adoption of imaginative programs. The background material and the submissions to the Task Force include specific examples of best practices.

We are of the view that there should be better mechanisms by which financial institutions may demonstrate their accountability to the community they serve. Certainly, the malaise that seems to exist in terms of the public perceptions of the banks and other financial institutions suggests that more should be done. We make a number of recommendations that we believe will substantially improve accountability and provide a framework for continuing dialogue between financial institutions and the Canadian public and its governments. In particular:

- all financial institutions that contribute data to the comprehensive survey on small business finance should be required to make that data public so that institutional performance can be identified;
- each federally regulated deposit-taking institution and life insurance company should be required to provide one or more annual Community Accountability Statements to describe its contribution to the community and to identify emerging community needs to which it intends to respond. Such statements should be filed with the Minister of Finance who should table them with the Standing Committee of the House of Commons on Finance; and
- provincial governments are urged to introduce a similar requirement for institutions within their jurisdiction.

Improving the Regulatory Framework

Canada has a strong prudential regulatory system that, in many respects, is a model that many other countries are now emulating. But the world is changing quickly, and new and complex types of risk require new approaches. In addition, it is important that the relevant regulatory structures support broad public interest goals, such as enhancing competition and protecting consumers.

We believe that the federal prudential regulatory framework can and should be further improved.

To this end, we recommend that:

- the mandate of the Office of the Superintendent of Financial Institutions (OSFI) be amended to recognize that OSFI has the responsibility to administer consumer protection provisions of relevant federal legislation, and also has a responsibility to balance competition and innovation considerations with its present statutory obligations in respect of safety and soundness;
- OSFI's governance structure be strengthened by adding a board of directors to the Office;
- regulatory overlap be reduced by transferring the regulatory responsibilities of the Canada Insurance Deposit Corporation (CDIC) to OSFI and amending CDIC's mandate accordingly;
- governments work aggressively to eliminate overlap in prudential regulation, both between federal and provincial governments and among provincial governments. In particular, efforts should be made to develop central, common, electronic databases and to delegate solvency regulation to OSFI wherever possible; and
- federal regulatory practices should be streamlined. The report sets out several areas where further action is appropriate.

We also considered various consumer insurance and compensation plans with a view to assessing whether changes should be made to reflect the changes that are taking place in the industry and in the marketplace. We concluded that the various plans are generally working well. However, we believe that the government-backed CDIC insurance, which is available to deposit-taking institutions, gives them a competitive advantage in the marketplace compared to the industry-run life insurance protection program (CompCorp). We recommend that this competitive advantage be removed by integrating the two plans.

Finally, we consider the provision of financial services by providers with no physical presence in Canada and we propose a framework that provides greater legal certainty than now exists with respect to such transactions. Within this framework, we propose a certification process for foreign lenders who wish to make loans to Canadians without establishing a physical business presence in Canada that will facilitate this source of competition, subject to undertakings that will protect Canadian borrowers.

Conclusion

Our recommendations, taken together, will help move us toward our vision of the financial sector that will best serve Canadians.

But we register two cautions.

First, change is accelerating and time is short. We expect and look forward to public discussion of our report. We also urge, however that the debate be focussed and that action be timely. To delay is to deny opportunities that we think can be realized and to make the challenges facing us harder to manage.

Second, a framework is merely a framework. It is important, but change will come through the actions of leaders, entrepreneurs and innovators. Allowing banks to be started more easily doesn't mean that they will be. Providing greater transparency of documents doesn't mean that consumers will take the time to read them or to make responsible decisions. Giving government more regulatory flexibility doesn't mean that it will be well-used. All Canadians have a role to play, in their own spheres of influence, if we are to work successfully together to build a financial sector that will serve Canadians and Canada well.

The changes are inexorable and we cannot ignore them or pretend they do not exist. For financial institutions, their customers and public policy, reliance on the status quo is no option.